CIA/OER/S-07502-75 WORLD ECONOMIC REPORT APR 75

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CENTRAL INTELLIGENCE AGEN[redacted]
WASHINGTON, D.C. 20505

CIA\OER \S-07502-75

15 April 1975

[redacted]

MEMORANDUM FOR: Mr. Carl Bell
Senior Staff Member
Council of International
Economic Policy

SUBJECT : World Economic Report

In response to your 7 April request we are forwarding the attached paper, World Economic Report, for use in briefing the Economic Policy Board on 2 May. In addition to the text we are preparing six graphics which are also being transformed onto briefing boards for your 2 May presentation. If you have no changes we will print the report as a handout to members of the EPB and prepare a briefing style text for your use. Please pass your comments to

STAT

[redacted] URICE C. ERNST
Director,
Office of Economic Research

Attachment:
As stated

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WORLD ECONOMIC REPORT

Approved For Release 2002/08/15 : CIA-RDP86T00608R000600030029-3

The Global Setting

1. The world has prospered from growing economic interdependence since World War II. Developed and less developed countries have all benefited from the enormous expansion of world trade. National and multinational firms have larger markets, workers more income, and consumers a higher standard of living than ever before. The accompanying integration of financial markets including the Eurodollar market has provided the needed capital. For most of this period, US economic power and with it the dominant role of the dollar remained unchallenged.

2. This growing interdependence, however, has created new problems. Nations are now much more vulnerable to the actions of others than in years past. Efforts to avoid or reduce unemployment in one country have often cost jobs elsewhere. Reconciling growth, price, and balance of payments policies is now more difficult. And the trade impact of policies designed to stimulate domestic economic activity has become increasingly large. For the US, this process has reduced the impact and influence of what we do on the international economic scene while at the same time increasing measurably the impact of decisions on our economy taken by others.

3. The severe economic disturbances of the past two years have sharply focused the spotlight on the problems of interdependence. These disruptions beyond the control of any one country included:

- o Rapid world inflation stemming from food shortages, an unprecedented synchronized business upturn in the major developed countries and the dramatic oil price hikes by the OPEC cartel followed by:
- o A deep world recession brought on by a near global shift to anti-inflationary policies, a synchronized downturn in the industrial countries and the contractionary impact of oil price rises.
- o International financial strains and balance of payments problems caused by the huge increase in export earnings of OPEC countries.

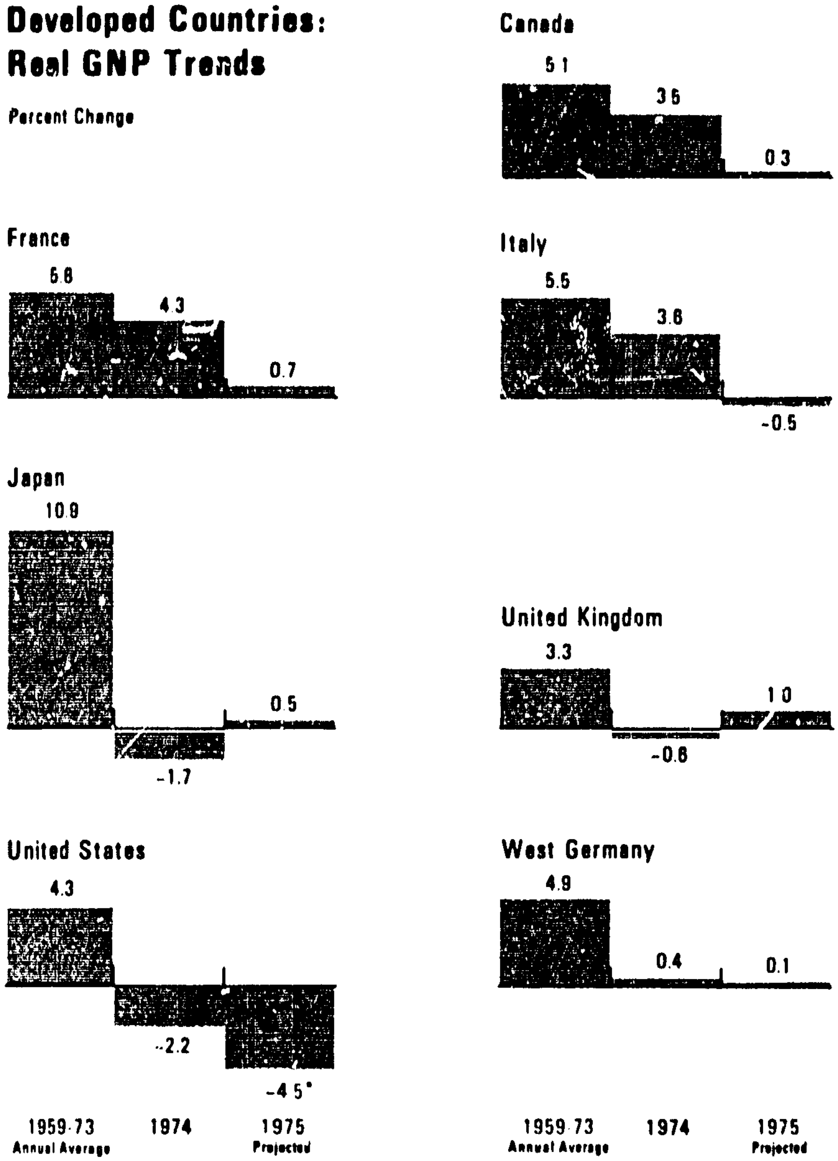
4. The severity, persistance and global nature of these problems threaten to slow or even reverse the trend towards economic interdependence as nations seek individual solutions to global problems. The longer these problems persist, the greater the risk that go-it-alone policies will be adopted.

<u>Recession -- The Number One Problem</u>

5. The major developed countries have made measured progress in dampening inflation and coping with payments difficulties. But solving the problem of slow or no economic growth has proved much more intractable. The recession has already involved more countries, lasted longer

Developed Countries: Real GNP Trends

Percent Change



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*OECD forecast

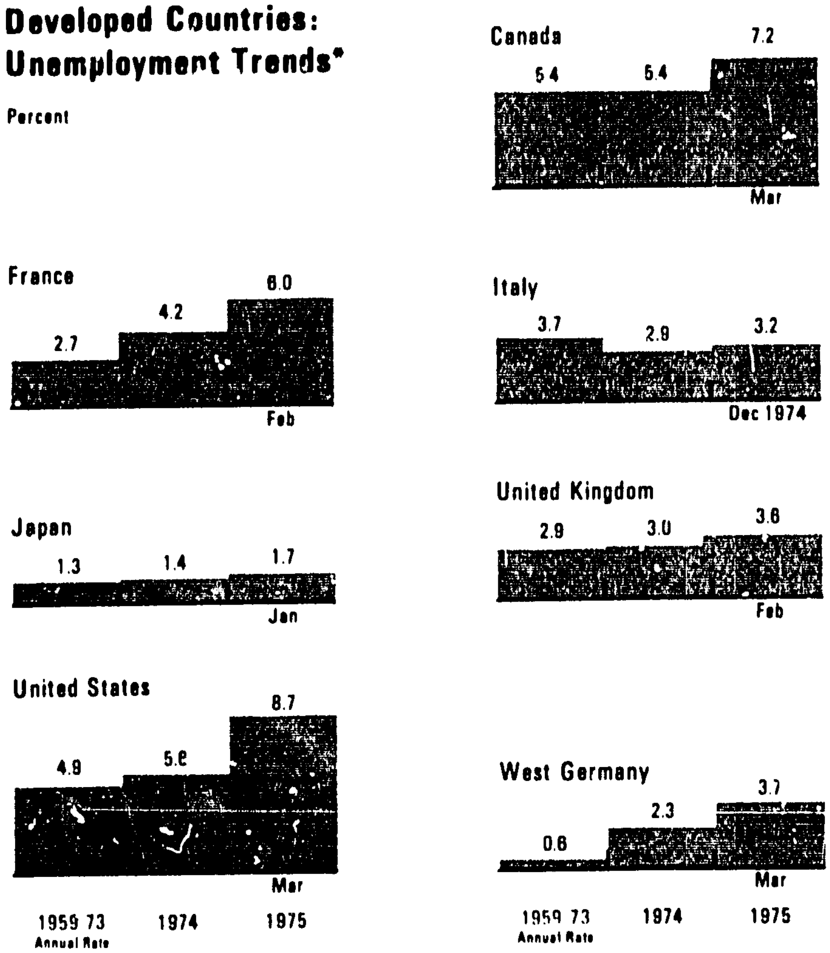
and gone deeper than in any previous postwar slump. Collectively the real GNP of the major industrial countries fell -0.6% last year, compared with a long-term average growth of 5.4%. The US had the poorest performance of all with a decline in real GNP of 2.2%. Japan followed closely with a -1.7% and the UK with a -0.6%. Growth in all other major countries -- while still positive -- was well below the long-term average.

6. The considerable uncertainties last year caused by the oil embargo, skyrocketing prices and tight money policies eroded consumer purchasing power and confidence. By mid-1974, business investment began falling in response to a profit squeeze evident in all major industries. Faced with weak demand both at home and abroad, firms accelerated production cutbacks toward yearend. In the United States and Japan, the fall in demand substantially outpaced the decline in production. As a result there was a huge inventory buildup.

7. Although the cumulative effect of these downward pressures is still with us, economic activity should pick up somewhat in the second half of 1975. The inventory overhang is expected to be worked off about mid-year. In many countries, consumer confidence shows some signs of recovering, especially now that real wages are once again rising. In addition, the modest reflationary efforts undertaken by several countries should begin to take hold. For the year as a whole, however, the economies of Western Europe, Canada, and Japan will just about stagnate while US real GNP is expected to decline by 4.5%.

Developed Countries: Unemployment Trends*

Percent



*Data adjusted to US concepts

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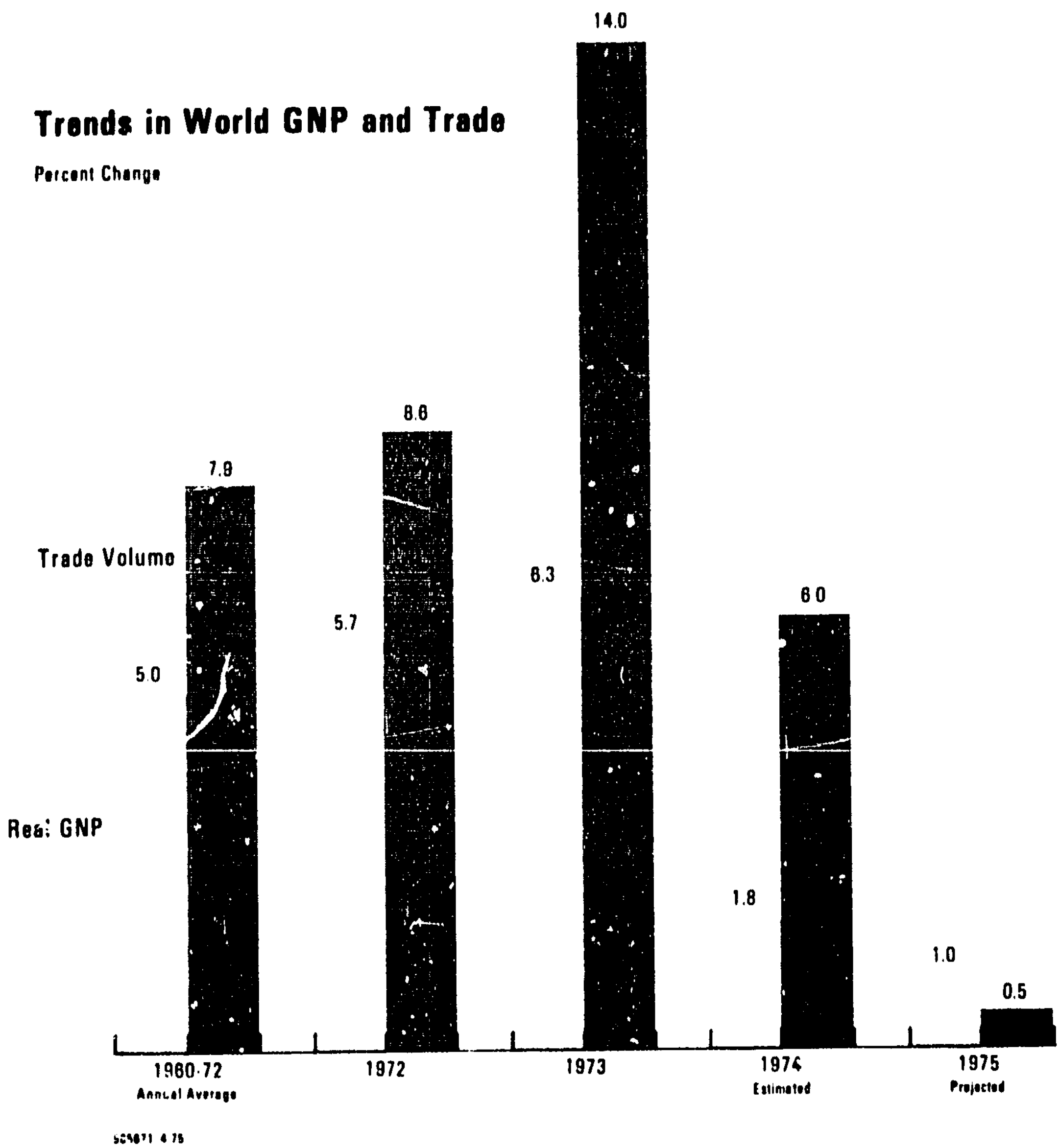

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No major country will grow more than 1%.

8. While prospects for the rest of the year are not especially bright, there are elements of instability that could dim that further. Unemployment rates are not likely to drop much from the current high levels. The jobless rate has hit postwar records in the United States (8.7%), Canada (7%), France (6%), West Germany and Britain (4%), and Japan (2%). Moreover, a growing number of workers have been put on short time everywhere. The recession has also sparked a rash of business failures, particularly in Japan and West Germany. Continuation of these trends could lead to a further erosion of business and consumer confidence.

9. A sharp falloff in world trade could also worsen recovery prospects. Although trade held up well most of last year, preliminary data suggest that a considerable falloff is now underway. Most major countries have experienced a substantial decline in export volume since late 1974. Rising protectionist sentiment, if it gets out of hand, could accelerate the trend. Several smaller countries, notably Australia, have already increased import barriers. Others are under strong pressure to raise import barriers and/or subsidize exports.

Inflation -- A Less Pressing Problem

10. After climbing at record rates in the first half of 1974, the price rises eased substantially towards yearend.

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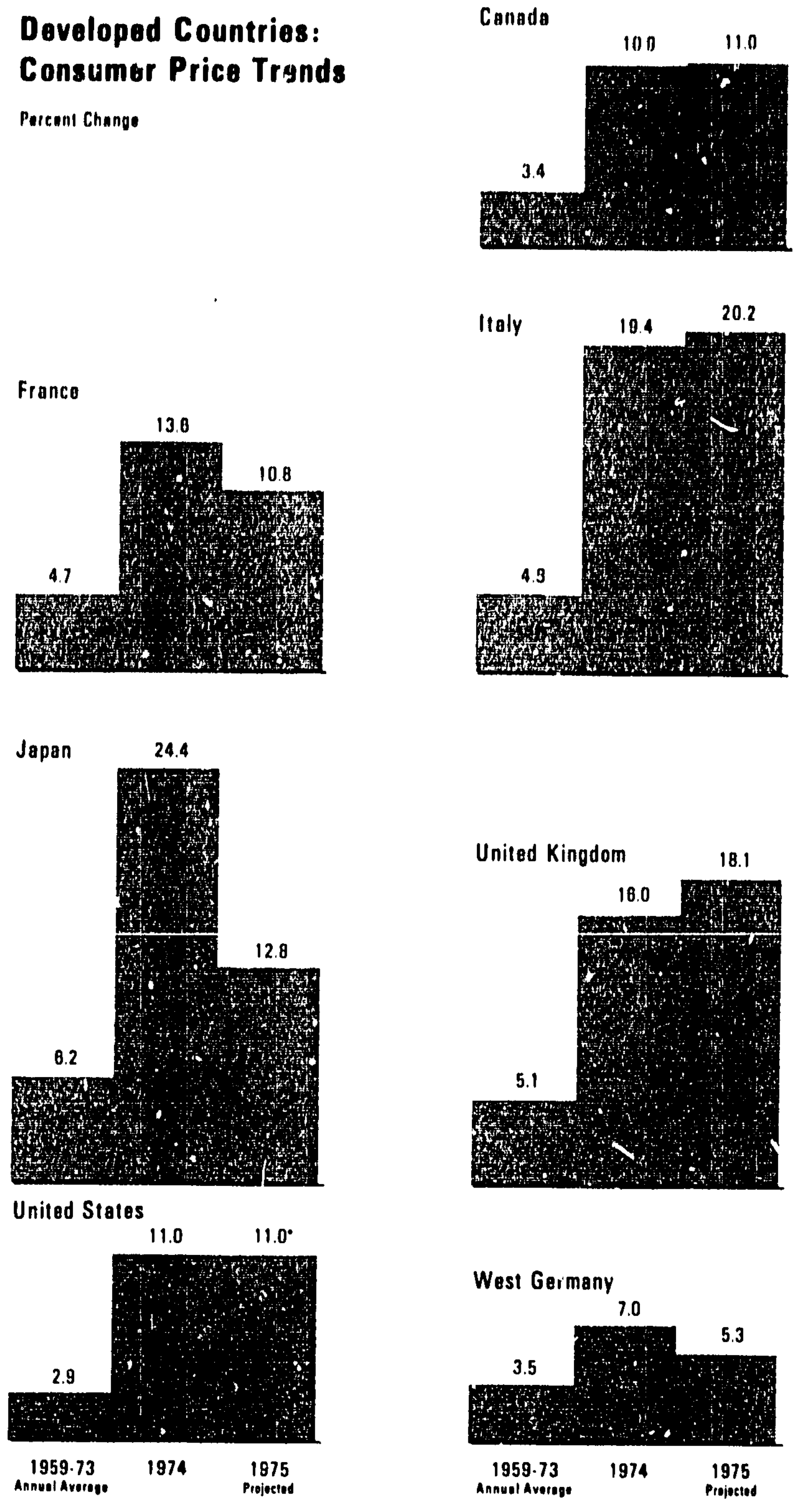
Developed Countries: Consumer Price Trends

Percent Change



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*OECD forecast

The 32.7% increase (annual rate) in prices during the first half reflected the huge oil price rise and higher commodity prices. With demand in major countries off sharply, raw material prices tumbled during the second half, dropping 40% between June and December. The downturn in demand also resulted in price reductions for some industrial goods. As a result, the rise in overall wholesale prices was practically halted in most major countries by early 1975.

11. Consumer prices are reacting much more slowly. The rise in consumer prices, however, is expected to decelerate from the 15% pace of 1974 to annual rates of 11% in the first half of 1975 and 10% in the second. Currently, the major impetus to inflation is the rapid rise in unit labor costs that began last year. While wage rates are increasing, labor productivity will not improve much, so long as GNP stagnates. Cost pressures will be particularly severe in the United States, United Kingdom, Italy, and Canada where workers trying to catch up with past inflation are demanding large pay hikes.

12. For both consumer and wholesale price trends, the major uncertainty remains food supplies. Much of the increase in consumer prices during the second half of 1974 and early 1975 reflected higher food costs. Although world prices for raw foodstuffs have declined in recent months, the reduction will not be felt at the retail level for several more months. At the moment, prospects for a further weakening in food costs are good with US and other major grain producers expecting bumper crops. Most stocks are tight and poor harvests would

quickly set off another round of price hikes.

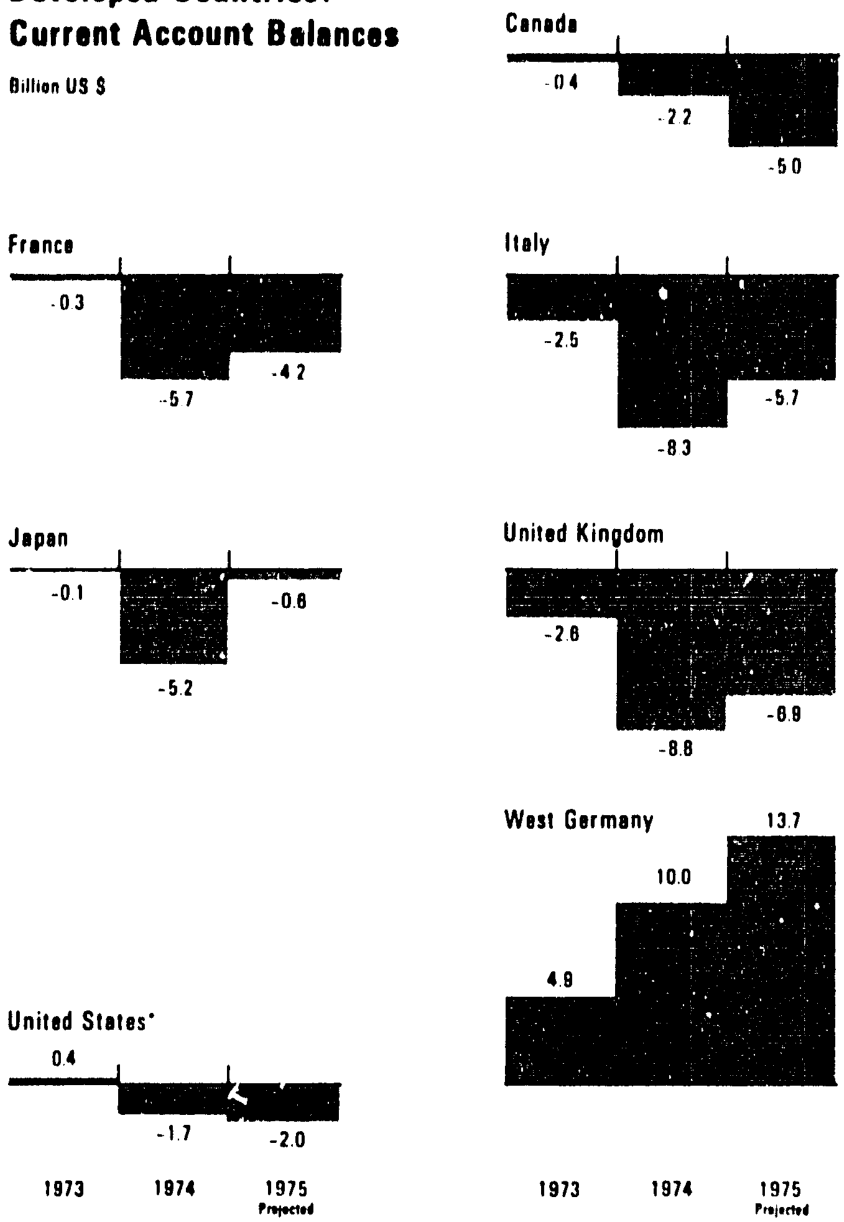
The Balance of Payments

13. The industrial countries have been able to cope with the impact of higher oil costs on their trade and payments positions. For the group as a whole the oil import bill in 1974 increased by nearly $60 billion, to reach about $87 billion. West Germany, Japan, and the United States were able to offset most or all of the increase by boosting exports. West Germany did particularly well, increasing its trade surplus by $8 billion and current account surplus by $5 billion. Italy, with a huge deficit, required bail-out assistance from West Germany and the European Community totaling $4 billion.

14. Excepting Canada, all major foreign countries should show some improvement in their current accounts this year. West Germany and Japan will have the greatest gains but France will also have a fair degree of success. Italy and the United Kingdom, despite some improvement will continue running huge current account deficits.

15. Altogether the current account deficit of the major countries is expected to total some $11 billion this year, or half last year's level. In large measure, the improvement stems from a paring down of the huge trade deficit with OPEC countries. Because of higher prices, the recession, and conservation measures the volume and value of imports from OPEC will decline somewhat. Exports to OPEC are expected to

Developed Countries: Current Account Balances



*1974 and projected 1975 figures based on OECD estimates increase some 40% in value terms. The trade surplus of major countries with non-OPEC LDCs will increase by several billion dollars largely on the strength of higher export prices.

16. The major foreign countries should be able to avoid serious financing problems through the balance of 1975. Canada will be able to finance its record $5 billion current account deficit largely through private capital inflows and increased borrowing in the US money market. Borrowing from Arab countries is also on the rise. Continued borrowing from Arab oil producers should cover the $4 billion deficit in prospect for France. West Germany and Japan are in the best financial position. Tokyo's success in attracting foreign capital has recently prompted the government to liberalize restrictions on capital outflows.

17. Italy and the United Kingdom face rougher going, but should be able to muddle through another year. Rome is still finding it difficult to borrow in the Eurocurrency market, and its recent attempts to borrow directly from Arab oil producers have yielded little. Still, unless political crisis triggers a large outflow of capital, assistance from the various recycling funds and some drawdown of foreign exchange reserves -- currently around $3 billion -- should see Italy through the year. With $7 billion in reserves and an additional $3 billion in IMF drawing rights, the United Kingdom has ample resources to finance this year's payments deficit without resorting to trade restrictions.

Government Policies

18. The major foreign countries have done relatively little to stimulate recovery. Initially they gave priority to the battle against inflation. Their chief concern now is that stimulative policies could result in a wider trade deficit, exchange rate problems, and ultimately a resurgence of inflation. Rather than moving rapidly on their own, each prefers the United States to lead the next recovery.

19. West Germany is facing some pressure from its trade partners to reflate. Germany is in a particularly good position to expand because of its huge trade surplus and low in ation rate. Tokyo is also concerned that major foreign governments will press the Japanese to initiate expansionary policies in view of Japan's relatively large trade surplus. Although domestic pressures for expansionary measures are mounting, serious inflation and payments problems limit the action that the United Kingdom and Italy can take. Canada is essentially waiting for the United States to begin its recovery.

20. Fiscal measures taken by major foreign governments thus far will provide substantially less stimulus than the recently enacted US tax cuts. Among the major foreign countries,

- o West Germany has taken the most positive action with impplementation of a $6 billion tax cut -- equivalent to about 1.5% of GNP -- and introduction of tax credits for investment.
- o Japan has done little other than step up public works spending somewhat.

o Canada has avoided cutting taxes, but does plan a moderate budget deficit.

o French measures have consisted essentially of moderate investment tax credits and some increase in overall spending.

o Italy's policy calls for keeping the budget deficit at a minimum.

21. To dampen domestic pressures for more stimulative action most governments have stepped up special assistance to the unemployed and to industries facing serious financial problems. Bonn will have to cover a $2.5 billion deficit in the national unemployment fund this year, compared with a $900 million deficit last year and a $600 million surplus in 1973. Unemployment benefits have also been expanded in France, Italy and Japan. Tokyo has also allocated roughly $1 billion in long-term loans to industries hard hit by the recession.

22. Monetary policy has been eased slightly. The major countries, except for Japan, have cut central bank discount rates this year, and most have relaxed credit restrictions. In recent months, weak demand for loans and the drop in central bank rates have substantially brought down short-term interest rates in most countries. Because most major industries are operating well below capacity, however, lower interest rates and easier credit are having little impact on private

investment. In several countries borrowing is already running below credit ceilings.

Oil and OPEC

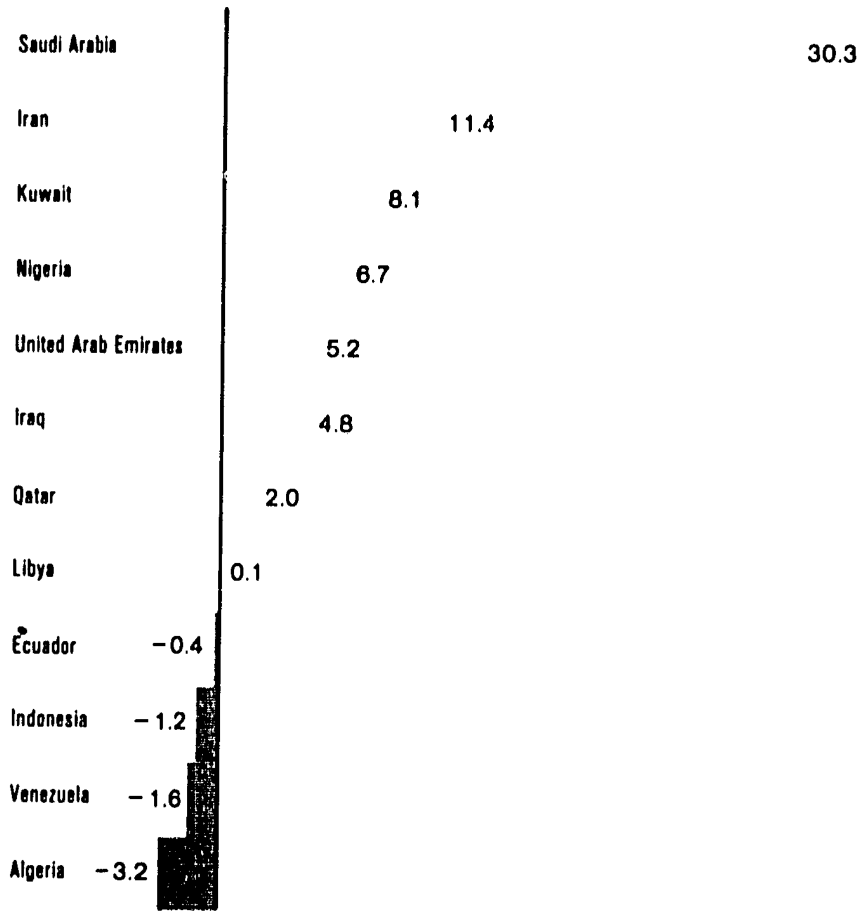
23. The global recession and subsequent drop in oil consumption have placed relatively few economic strains on the OPEC group. Sagging consumer demand is expected to cut OPEC oil exports to about 25 million b/d over the next several months compared with 33 million b/d on the eve of the oil embargo and a striking 14 million b/d below capacity. Saudi Arabia and a few other cartel countries with huge surplus oil reserves have been willing to cut production enough to keep prices high. Informal allocation of production cuts managed by the international oil companies, among other OPEC countries has been achieved without much difficulty.

24. The pressure on OPEC will ease substantially as fall approaches. Demand for OPEC oil is expected to rise to about 29 million b/d during the fourth quarter of 1975, permitting a substantial increase in output. Because the demand for OPEC oil is expected to increase in 1976 and again in 1977 as the economic recovery in OECD countries gains momentum, the contentious issue of production cuts will not recur until later in the decade.

25. As a group the OPEC countries will remain in a strong financial position for at least the next several years. The value of oil exports last year totaled $114 billion compared with imports of only $34 billion. The current account surplus

OPEC Countries:
Projected Current Account Balances in 1977

Billion U S $



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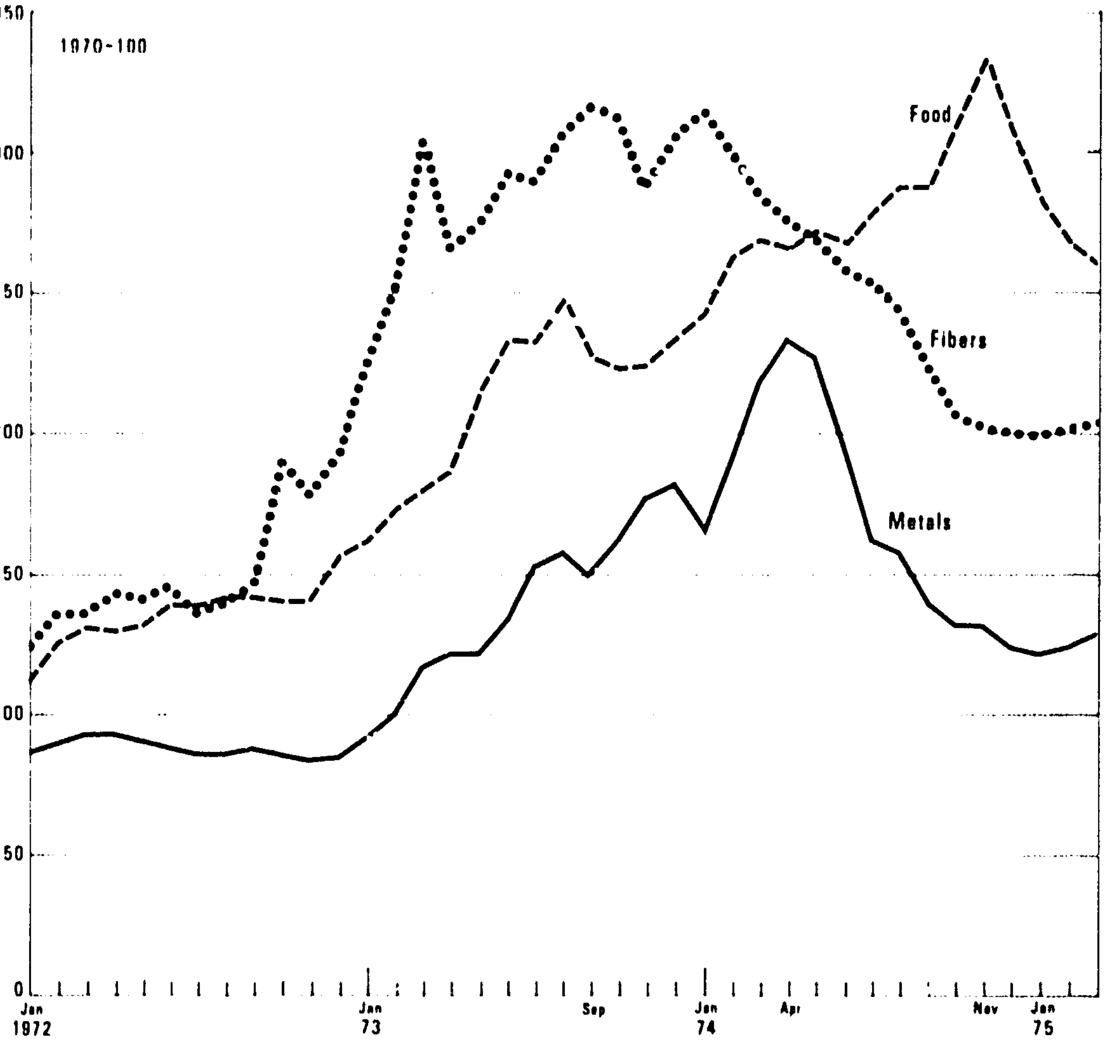
totaled $73 billion. Saudi Arabia accounted for more than one-fourth of the surplus. Most other OPEC countries had surpluses of $5 billion or more. During 1975-77 the OPEC group will have current account surpluses averaging $60 billion annually. By the end of 1977 they will have accumulated $270 billion in foreign assets.

26. The overall current account surplus of OPEC countries indicates the magnitude of the petrodollar recycling problem but conceals sharp differences in the prospective financial positions of individual countries. Seven OPEC states -- Saudi Arabia, Iran, Kuwait, Nigeria, the United Arab Emirates, Iraq, and Qatar -- should be free of balance of payments constraints. Interest earnings alone will be enough to finance Saudi imports by 1977. The remaining five countries probably will have current accounts in near balance or small deficit by 1977. None is likely to encounter serious balance of payments problems over the next three years. Under these circumstances we see no particular stress on the cartel through 1977 so long as Saudi Arabia continues to be supportive of OPEC pricing policies.

The Non-OPEC LDCs

27. Most non-OPEC LDCs have been hard hit by the extraordinary rise in oil prices and large increases in prices for food and imported manufactures. Higher prices for primary commodities exported by non-OPEC LDCs offset some of the rise in import costs, especially in early 1974. After midyear, however, prices

World Food, Fibers, and Metal Prices



for cotton, hides, rubber, and copper fell sharply. Food prices, although buoyant during most of the year, were also falling by yearend -- especially for coffee, rice, sugar, and copra. As a result of these trends their combined trade deficit in 1974 rose $15 billion to about $31 billion. Over 40% of the rise was directly attributable to oil.

28. Although the current account deficits of most non-OPEC LDCs were financed with little difficulty in 1974, problems will grow in 1975. Most of these countries entered 1975 with a lower level of foreign exchange reserves and larger potential current account deficits than in 1974. The prices of many of their raw material exports are still declining or, at best, remaining constant because of shrinking demand in major industrial countries. The prices they pay for manufactures continue to rise. Private capital flows to these countries are becoming less available, driving them increasingly to official bilateral and multilateral capital sources, including the IMF. To avoid growing balance of payments problems many LDCs will move to restrict imports, further cutting overseas sales of major countries.

29. The non-oil LDCs are also demanding much more from the richer nations. Some raw material producers would like to emulate the OPEC cartel while all hope to tap the OPEC riches. Although many will continue to make highly vocal demands, most are beginning to realize a more pragmatic approach is needed. Lacking the market share or financial strength to form effective

OPEC-like cartels, many LDCs are seeking to stabilize commodity prices in cooperation with the developed countries rather than through confrontation.

30. Chile, Peru, Zaire, and Zambia, members of the Intergovernmental Council of Copper Exporting Countries, are looking for a compromise route. The group wants a commodity arrangement modeled after the International Tin Council which attempts to maintain agreed floor and ceiling prices through manipulation of buffer stocks. Prospects for the formation of such an arrangement, however, appear poor. Many non-member copper producers, such as the Philippines are hopeful of expanding their share of the world market. Reasons for joining are less compelling for consuming nations currently benefiting from low prices. Moreover, few countries would be willing to build up copper buffer stocks at a cost roughly estimated at $750 million.

31. The United Nations Conference on Trade and Development (UNCTAD) and the LDC bloc of 86 non-aligned nations are seeking to establish an integrated program of international commodity stocking and market intervention arrangements. Little concrete progress has been made toward this objective. Financing was a major stumbling block at the February Dakar Commodity Conference of the non-aligned nations. Proposals calling for OPEC financing were rejected by the Arab oil producers, who insisted on further study and planning before they would consider committing funds.

32. The non-oil LDCs' only success so far has been the February 1975 EC agreement with associated LDCs, which included a new export revenue stabilization scheme. Although the amounts to be provided by the EC are small, they set a precedent for new and bigger programs. The politicization of commodity issues probably will intensify over the next year. The April Commonwealth conference in Jamaica, the forthcoming producer/consumer energy conference, the United Nations General Assembly special session in September, and UNCTAD IV in 1976 will all provide occasions for proposals and demands from third-world producers.